

December 16, 2004

The Honorable Frank H. Murkowski, Governor
Members of the Alaska State Legislature
Public Employees' Retirement Board
Alaska State Pension Investment Board
Employers and Plan Members of the System

We are pleased to present the Comprehensive Annual Financial Report (CAFR) of the Public Employees' Retirement System (PERS) (System) for the fiscal year ended June 30, 2004.

This report is intended to provide comprehensive information on the financial operations of the System for the year. Responsibility for both the accuracy of the data, and the completeness and fairness of the presentation, including all disclosures, rests with the management of the System. To the best of our knowledge and belief, the enclosed data is accurate in all material respects and is reported in a manner designed to present fairly the financial position and results of operations of the System for the year ended June 30, 2004. All disclosures necessary to enable the reader to gain an understanding of the System's activities have been included.

For financial reporting purposes, the System utilizes Governmental Accounting Standards Board (GASB) Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*; GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*; GASB Statement No. 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus*; and GASB Statement No. 38, *Certain Financial Statement Note Disclosures*. Assets of the System are presented at fair value. The actuarial value of assets and the actuarial accrued liability are presented in the required supplementary information following the notes to the financial statements.

The FY 2004 CAFR is divided into five sections:

- **Introductory Section**, which contains this letter of transmittal, the administrative organization of the System, and a list of the members serving on the Public Employees' Retirement Board;
- **Financial Section**, which contains the Independent Auditors' Report, management's discussion and analysis (MD&A), basic financial statements, required supplementary information, and additional information;
- **Investment Section**, which contains a message from the Chair of the Alaska State Pension Investment Board (ASPIB), a list of members serving on the ASPIB, a report on investment activity, investment results, and various investment schedules;
- **Actuarial Section**, which contains the Actuarial Certification letter and the results of the most current (June 30, 2003) annual actuarial valuation; and
- **Statistical Section**, which includes graphs and tables of significant data.

The Alaska PERS was established in 1961 to provide pension and postemployment healthcare benefits for eligible state and local government employees. Normal service, survivor, and disability benefits are available to all members who attain the age and service requirements of the System.

	PERS		
	FY04	FY03	FY02
Net Assets (millions)	\$8,177.3	7,391.5	7,412.8
Participating Employers	161	160	161

Reporting Entity

The System is considered a component unit of the State of Alaska for financial reporting purposes. Because of the closeness of the System's relationship to the State, it is included in the State of Alaska CAFR as a blended component unit.

The Commissioner of the Department of Administration, appointed by the Governor, is responsible for administering the System. In order to meet the statutory requirements of administering the System, the Commissioner appoints the Director of the Division of Retirement and Benefits. The Director is responsible for the daily operations of the System.

The Public Employees' Retirement Board prescribes policies and regulations, hears appeals, and approves employers' contribution rates prepared by the System's independent actuary.

The ASPIB has statutory oversight of the System's investments and the authority to invest the System's monies. Actual investing is performed by external investment firms and investment officers of the Department of Revenue, Treasury Division listed in the Investment Section of this report. The Treasury Division is responsible for carrying out investment policies established by ASPIB.

Major Initiatives

The System continues to make progress on completing several on-going projects. Most of these efforts focused on improvements in technology, improving methods for members to obtain information about the System and their benefits, and continued compliance with accounting requirements of the Governmental Accounting Standards Board (GASB) and the Financial Accounting Standards Board (FASB) as applicable in the circumstances.

The Public Employees' and Teachers' Retirement Boards have been looking at ways to reduce costs to the employers and address the underfunded status of the Systems while also balancing the need to provide adequate benefits in order to effectively recruit and retain new members. A "Tier subcommittee" was developed to look at the possibility of adding a Tier IV in the PERS and a Tier III in the TRS. These new tiers would provide pension and postemployment healthcare benefits at levels the same as or less than current tiers. The Tier subcommittee has been meeting for almost a year and surveyed employers, employees, and benchmarked current Tiers with other states pension benefits. In order to accomplish this project the Tier Subcommittee used the services of the System's actuarial consultant to review and analyze the results of the study and determine the impact on the Systems. The Tier subcommittee did make a formal recommendation about a Tier redesign to the respective boards in November 2004.

Independent Audit

The System's annual audit was conducted by the independent accounting firm of KPMG LLP. The auditors' report on the basic financial statements is included in the Financial Section of this report.

Actuarial Valuation

An actuarial valuation of the System is performed annually. An assumption experience study is performed at least every other year. The actuarial firm, Mercer Human Resource Consulting, completed the actuarial reviews and valuations as of June 30, 2003, and served as technical advisor to the System. Actuarial certifications and supporting statistics are included in the Actuarial and Statistical Sections of this report.

Professional Services

Professional consultants are retained to perform professional services that are essential to the effective and efficient operation of the System. A list of consultants is provided in the Introductory Section with the exception of investment professional consultants, who are listed in the Investment Section of this report.

Certificate of Achievement

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Alaska Public Employees' Retirement System for its comprehensive annual financial report for the fiscal year ended June 30, 2003. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized comprehensive annual financial report. This report must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We are confident that our current comprehensive annual financial report continues to meet the Certificate of Achievement Program's requirements. Therefore, we are submitting it to the GFOA to determine its eligibility for another certificate.

Future Employer Contribution Rates

The System's consulting actuary presented the results of the June 30, 2003 actuarial valuation report to the administrator and the board. The assumptions and benefits are explained in the Actuarial Section of this report.

Based on this most recent valuation report, the System has a funding ratio (assets of the System divided by the total liabilities for pension and postemployment healthcare) of 72.8%. The unfunded portion of the System's liabilities totals approximately \$2.9 billion. The unfunded liability is amortized over a 25 year period, as established by the Board. In order to bridge the gap between assets and liabilities of the System, the employer matching contribution rate would increase over the same 25 year period from the Fiscal Year 2004 rate of 11.77% to approximately 30% in Fiscal Year 2028 if the System earns the assumed rate of 8.25%. The current asset allocation that the Alaska State Pension Investment Board for the System's investments is expected to provide a five year median return of 7.72%.

While investment returns in Fiscal Year 2004 of 15.08% exceeded the actuarial assumed rate of 8.25%, one good year does not make up for the three prior years of earnings less than the assumed rate. Any time the System earns less than the assumed 8.25%, the impact typically will be an increase to the employer

matching contribution rate. Since the three prior years rates were less than the assumed rate by 4.58% to 13.73%, these differences severely impacted the funding ratios, which in turn results in increased rates to the employers.

Besides the obvious impact of investments, the System also experienced significant increases in healthcare costs. In order to properly accrue (build up) assets to pay for the future "more expensive" health benefits, the System needs to charge employers a higher rate to offset those costs. The System has assumptions in place to account for healthcare costs, but if cost increases exceed what the System assumes, the impact is to increase the employer matching contribution rate.

For additional information on how a defined benefit system like PERS operates, the Division has developed a "white paper" that describes how the System is funded by revenues from plan members, employers, and investments, and where System costs are. This "white paper" is titled "Employee Benefits and Retirement System Funding" and is located at www.state.ak.us/drb/pers/perspublications.htm.

Currently, the Alaska PERS and TRS are rare in that these plans constitute two out of eight retirement systems that pre-fund and account for medical costs. The other three states that do this are Ohio, Michigan and Kentucky. The PERS and TRS systems are fortunate in that the creators and administrators of the Systems had foresight to fund the healthcare costs in advance. The remaining 120 other major governmental retirement systems only account for their current annual liability for healthcare costs. Once GASB #45 is effective in 2006/2007, all retirement systems will have to account for their future healthcare costs, similar to what our System already reports. So, current comparisons to other systems will be comparable once other systems start reporting their liabilities like PERS and TRS.

Acknowledgments

The preparation of this report is made possible by the dedicated service of the staff of the System. It is intended to provide complete and reliable information as a basis for making management decisions, as a means of determining compliance with legal provisions, and as a means of determining responsible stewardship of the funds of the System.

The report is being mailed to all employer members of the System. They form the link between the System and the membership. Their cooperation contributes significantly to the success of the System. We hope the employers and plan members find this report informative.

We would like to take this opportunity to express our gratitude to the Public Employees' Retirement Board, the Alaska State Pension Investment Board, the staff, the advisors, and to the many people who have worked so diligently to assure the successful operation of the System.



Ray Matiasowski, Commissioner



Kevin Brooks, Deputy Commissioner



Kevin Worley, CPA, Defined Benefits Accounting Supervisor

Respectfully submitted,



Melanie Millhorn, Director



Anselm Staack, CPA, JD, Chief Financial Officer

Certificate of Achievement for Excellence in Financial Reporting

Presented to

Alaska Public Employees' Retirement System

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 2003

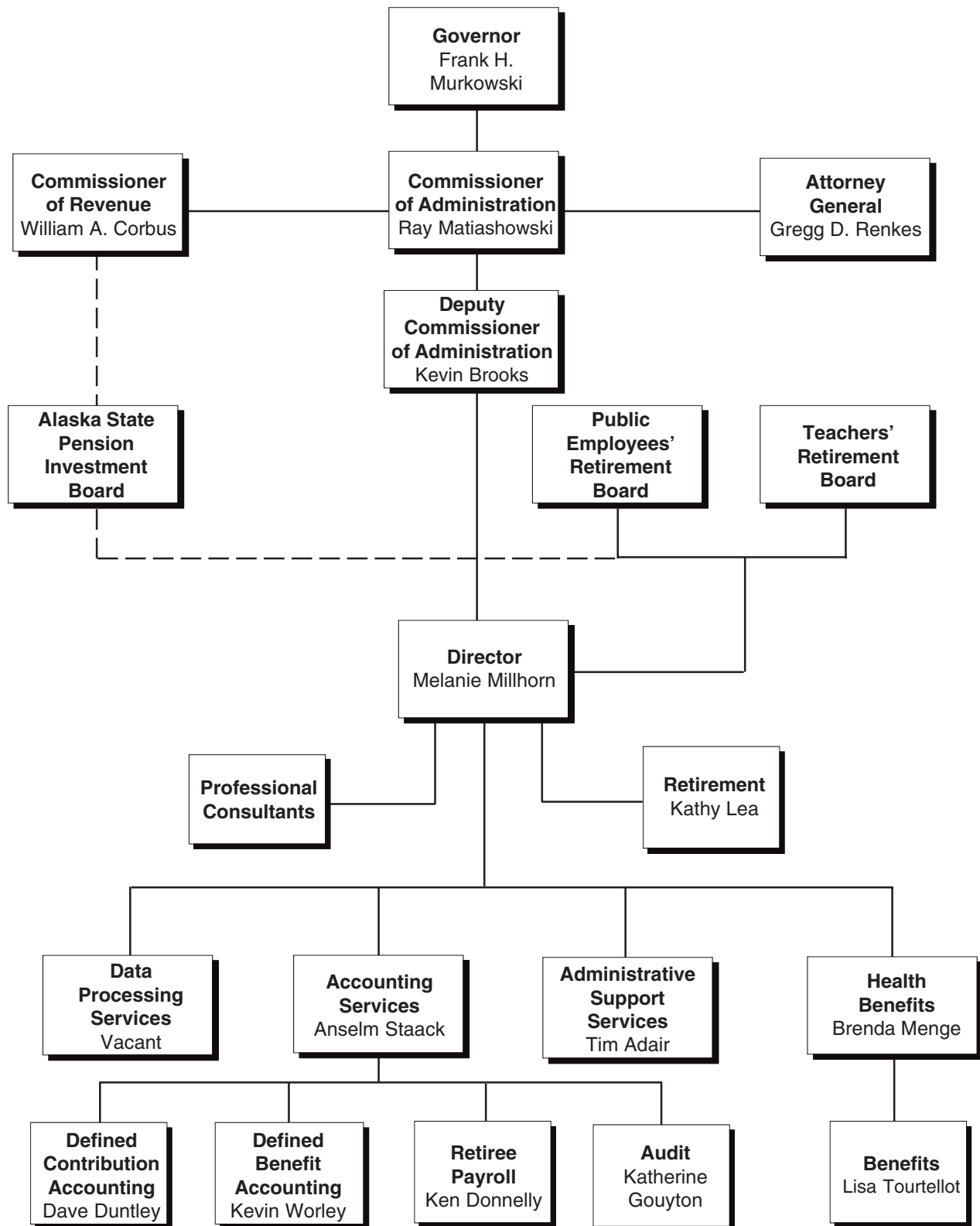
A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



President

Executive Director

ORGANIZATION CHART



Section Responsibilities

The **Retirement Section** is responsible for providing comprehensive retirement counseling to the participating members and employers in the plan. The section appoints members to retirement benefits and maintains benefit payment information.

The **Benefits Section** is responsible for the administration of group health, disability, and life insurance. This section provides benefits counseling and plan change information to the membership.

The **Defined Benefit Accounting Section** is responsible for maintaining the employee and employer records and accounts in each of the defined benefit plans administered by the Division, producing financial statements and reports, and assuring compliance with the Internal Revenue Service requirements for defined benefit plans.

The **Defined Contribution Accounting Section** is responsible for accounting, plan operations, and financial activities related to the defined contribution plan systems administered by the Division.

The **Data Processing Services Section** supports the information systems the Systems use. Responsibilities include planning, development, data base design, programming, and operational support of the data processing systems, including the Local Area Network.

The **Administrative Support Services Section** is responsible for budget preparation, fiscal management of appropriations, procurement of professional services, supplies, and equipment. The section manages the systems' record center containing the member's physical records and performs other administrative functions such as legislative tracking and personnel management.

The **Retiree Payroll Section** is responsible for issuing monthly and on-demand retirement benefit payments to eligible retirees or their beneficiaries. The section maintains accurate records for reporting benefit recipient tax statements and reporting and paying withheld income taxes, garnishments, and IRS levies.

PROFESSIONAL CONSULTANTS	
Consulting Actuary Mercer Human Resource Consulting <i>Seattle, Washington</i>	Legal Counsel Virginia Ragle Kathleen Strasbaugh Assistant Attorney Generals <i>Juneau, Alaska</i>
Independent Auditors KPMG LLP <i>Anchorage, Alaska</i>	Legal Counsel - Retirement Boards Wohlforth, Vassar, Johnson & Brecht <i>Anchorage, Alaska</i>
Benefits Consultant Deloitte & Touche, LLP <i>Minneapolis, Minnesota</i>	Consulting Physicians Kim Smith, M.D. William Cole, M.D. <i>Juneau, Alaska</i>
Third Party Health Claim Administrator Aetna Life Insurance Company <i>Walnut Creek, California</i>	

A list of external money managers and consultants for the System can be found on pages 52-53, and the Schedule of Investment Management Fees on pages 59-60.

PUBLIC EMPLOYEES' RETIREMENT BOARD

(as of June 30, 2004)



George Sullivan, Chair

Term Expires: June 30, 2006

George Sullivan grew up in Alaska. After graduation from Valdez High School, he joined the Army during WWII and served in the Aleutians. George represented the Anchorage area in the legislature in the mid 60's and was mayor of Anchorage from 1967 to 1982. He has always been active in the community and continues to give leadership to a number of organizations in Alaska, including The Anchorage Senior Center, Boys and Girls Club, Enstar Gas Board, Pioneers of Alaska, and the Veterans of Foreign Wars. George lives in Anchorage with his wife, Margaret. They divide their retirement days between a very appreciative community and the families of their 9 children, which include 15 grandchildren and 1 great-grandchild.



Alyce Hanley, Vice Chair

Term Expires: June 20, 2008

Alyce Hanley has lived in Anchorage since 1971. She graduated from high school in Pawtucket, Rhode Island and completed her nurse's training at the New England Deaconess Hospital School of Nursing in Boston, Mass. She was elected to the Anchorage School Board in 1981 and to the Alaska House of Representatives in 1984. After serving three terms, she chose not to run for reelection. In 1993, Mrs. Hanley was appointed to serve as a Commissioner with the Alaska Public Utilities Commission. She retired from that position in April 1999.

Alyce enjoys family activities with her five sons, their wives and seven grandchildren, all of whom live in the Anchorage area.



Bronk Jorgensen

Term Expires: June 20, 2010

Bronk Jorgensen was born in Jackson Hole, Wyoming. He became an Alaskan resident in 1978, before he was one year old. Bronk attended Tok School, the University of Alaska Fairbanks and attended the University of Pittsburgh, Semester at Sea program, graduating with a degree in Business Administration.

Bronk lives in Tok and is the owner/manager of All Alaska Gifts and Crafts and Jorgensen Realty. He is also a member of the Tok and State of Alaska Chambers of Commerce and was the 2002 recipient of the Chuck West New Pioneer Award from the Alaska Travel Industry Association.

Bronk enjoys Alaska's hunting, fishing and outdoor activities.

**Frank Narusch**

Term Expires: April 24, 2006

Frank Narusch has been an Alaskan resident since 1952. Raised in the coal mining camp of Suntrana on the Healy River, he boarded away to attend high school at Monroe High School in Fairbanks and Copper Valley School in Glennallen. While attending Seattle University, he worked summers commercial fishing in Cordova, coal mining in Suntrana, and surveying and inspecting projects around Fairbanks and Valdez for the Department of Highways (now DOT&PF). After receiving a degree in civil engineering in 1966, he began his professional career with the Department of Highways. During his 31 years of State employment, he held positions as Construction Project Manager, Regional Materials Engineer, Contract Claims Engineer, and Professional Services Chief. While with the State, he was active with the Alaska Public Employees Association.

He enjoys weekly breakfast get-togethers with retired friends as well as summer travel, camping, and exploring back roads around the State.

**James "Pat" Wellington, Chair**

Term Expires: April 5, 2008

Pat Wellington was born in Ketchikan, Alaska and graduated from Douglas High School. He served two years in the U.S. Army and started his law enforcement career with the Seward Police Department in late 1955. He served as Deputy U.S. Marshal, Alaska State Troopers; Chief of Police of Juneau; Deputy Commissioner and Commissioner of the Department of Public Safety; and retired in 1977 as Director of the Alaska State Troopers. Mr. Wellington is also a trustee of the Alaska State Pension Investment Board.

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